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BRIEFING MEMORANDUM

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TO: The Secretary

FROM: EB - Willis C. Armstrong WCA

Monthly Report

The Economic Consequences of Oil Prices

The drastic increase in oil prices decided upon by the producing countries constitutes an economic phenomenon of great magnitude which will have long-term basic, pervasive, and as yet somewhat unpredictable consequences for the entire world economy. The increases in prices from early October until the end of December introduce a multiplier of four in any calculations of the cost of oil in the world economy. As much as 50-60 billion dollars can be added to the world's import bill for oil during 1974, if prices are not raised any further. This is something more than 10% of total world trade. Certain conclusions are obvious:

1. The income of oil producing countries will rise astronomically.

2. The outlays of all oil importing countries will increase in similar measure.

3. The oil producing countries will accumulate large surpluses of currency.

4. The oil importing countries will in the aggregate go into deficit on merchandise trade and perhaps in total balance of payments terms.

5. Interrelationships between currencies used in world trade will be altered in a way that cannot yet be foreseen.

6. There will be a new source of investment capital - the oil producing countries.

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7. Inflationary forces in all countries will be accelerated.

8. Poorer countries will be hit the most.

Much will depend on how the oil rich countries dispose of their resources. To the extent they buy goods and services from advanced countries for their own development, or finance the development of poorer Arab countries, some of the extra oil revenue will return to the advanced countries in payment for exports. To which countries it returns depends on the relative competitiveness of the various economies and on the nature of political relationships between the governments concerned.

The oil revenue that is not used for the purchase of goods and services would presumably be held in liquid form or be invested in long term assets in developed countries.

The countries which are successful in competing for the export business and capital of the oil rich states will manage without balance of payments difficulties although they may all run deficits on their trade account. Other countries which are unable to increase their exports to the oil countries or attract oil capital may have to borrow to finance their deficits, change their exchange rates, apply capital controls, or cut back on imports other than oil. Balance of payments difficulties of this kind following the imposition of the high oil prices could lead to excessive restrictions on imports, competitive devaluations, and other actions that would have the earmarks of a trade war between developed countries, collectively made poorer by spiraling oil prices.

Under these circumstances it is important for the developed countries:

--to explore in the Energy Action Group the implications of the new oil prices for their balance of payments and to take coordinated action to avoid economic warfare among themselves;

--to seek some kind of understanding with the oil rich countries concerning the parameters of possible future price movements and decisions.

It would also be prudent to continue for the time being to hang on to the flexible exchange rate system we now have, so that the world economic system can adjust more easily to the impact of the oil price rise, and so that some clearer indications may be obtained as to where this course of events will lead exchange rates.

The developing countries will be particularly hard hit. Energy imports are often a major component of the foreign exchange outlays of developing countries, since many of them have no indigenous energy resources. Tripling or quadrupling the cost of energy may make the difference between solvency and insolvency on foreign exchange account, and may well turn a modest rate of growth for developing countries into no growth at all, or to a decline in economic activity. Furthermore, the imports of the less developed countries of goods other than oil will also cost more because of the increased cost of energy in the developed countries. There will be less aid money available from advanced countries for the developing countries, because all the developed countries will be feeling poor.

The oil-rich countries could be an important source of investment capital for the developing countries, either directly or through the purchase of the bonds of aid institutions like the IBRD. The development by these institutions of suitable investment instruments, protected against depreciation and exchange risk, might attract substantial oil funds. Were this to happen, benefits would flow not only to the poor countries who would receive more aid but also to the industrial world which would earn these oil funds by providing goods and services to the developing countries.

The political consequences of the sharp oil price increase are not hard to conjecture. The prosperity and enormous economic growth of Western Europe, North America, and Japan in the past 25 years have been built largely on the greatly expanded use of inexpensive energy. Political relations among the developed countries have not by any means been free from tensions and differences, even in a time of such prosperity. When all are reduced to a deficit position vis a vis oil-rich countries, their political relations with each other will be exacerbated and filled with mutual suspicion, unless a spirit of cooperation can respond to some outstanding leadership in this crisis.

The political consequences for developing countries are even more unpleasant to contemplate. Most developing countries live a kind of hand-to-mouth political and economic existence anyway, and the difference between bankruptcy and a good credit rating is frequently a very narrow margin, as is the difference between being in or out of power. One cannot foresee anything but trouble for the regimes of developing countries which do not have their own energy supplies.

The foregoing analysis is only of the most general nature, but it suggests many lines of urgent economic inquiry which we shall pursue, and a re-examination of the bases of many policies, to determine how best to counteract what can only be perceived at this time as a blow to the heart of a highly sensitive and complex international economic system. It constitutes a major task for all countries so affected, and the urgency is of the first order.

The oil producing countries are the possessors of wealth beyond any conceivable expectation of some years ago. They are aware that these resources are finite, and that they must capitalize on them while they can. They are not invulnerable and can be dealt with, because they themselves must live now and in the future in some kind of consonance with an international economic system, and it is not in their interest to wreck it. The most intense kind of consultation among all developed countries with the oil producing countries is urgently called for.

The less developed countries which do not have oil should be encouraged to apply political pressure on oil producing countries. This could be a very important factor at this time.

The policy problems are 1) how to harness the resources of the developed countries in such a way as to reach understanding with the oil-rich countries, 2) how to arrange monetary adjustment mechanisms in such a way as to avoid disaster, 3) how to assure that the oil-rich countries pick up their proper share of the burden of helping the LDC's with aid, trade and investment. The United States is the only country which is in a position to do what is necessary in terms of the political leadership required to enable the world economic system to adjust itself to the revolutionary impact of the oil price increases.

Sale of U.S. Aviation Equipment to USSR

The sale of U.S. aviation equipment raises both security and economic issues for the U.S. Government. It poses the question of the meaning of detente for technology-based U.S. industries.

The three major U.S. manufacturers of commercial transport aircraft--Boeing, McDonnel Douglas and Lockheed--

are discussing with the USSR essentially similar proposals. These involve the sale of their wide-bodied aircraft, the provision to the USSR of technical assistance for Soviet aircraft production facilities, coproduction arrangements, cooperation in the design of new aircraft types, and assistance in securing U.S. certification for the marketing of the Russian YAK-40 trijet.

We favor the sale of U.S. civil aircraft to the USSR. Were the Soviets to purchase a substantial number of U.S. wide-bodied aircraft, we would not object to negotiating a bilateral airworthiness agreement to permit U.S. certification of the YAK-40.

However; the technical assistance and joint venture aspects of the proposals, involving the export of advanced technology, pose significant national security problems, and bear also on the evolving USG policy on technology transfer. These programs would enhance the Soviet Union's ability to compete with the U.S. for aircraft sales in third markets. The successful U.S. firm, if there is only one, would have an overwhelming competitive advantage in world markets.

The sale of U.S. wide-bodied aircraft to the USSR is unlikely without some technical assistance from the U.S. seller. The East-West Trade Policy Committee Working Group agreed this month that guidelines should be provided the companies as to what types of technology would, and would not, be licensed for export to the USSR. Our goal should be to include in the list enough technology to make possible the sale of U.S. aircraft, while safeguarding our national security and economic interests. Given the obvious Soviet desire to acquire the latest technology, this will be a formidable task.

Since January 1973, the USSR has also manifested an interest in acquiring air traffic control (ATC) equipment to bring the Soviet system up to ICAO standards. The Soviets seem to desire foreign-manufactured ATC equipment for a system for the high-density traffic areas in the western portion of the USSR.

U.S. companies exhibited ATC equipment at a symposium in Moscow in July and three have submitted proposals to the USSR. The Soviet Ministry of Aviation has pressed the U.S. Federal Aviation Administration to provide the software for such a system. The FAA has agreed to do so in principle, on a reimbursable basis, if U.S. manufactured equipment is used and export licenses are approved. We face competition for this export sale from the French and British.

-- The sale of U.S. manufactured equipment would be an important export. It would also contribute directly to the safety of U.S. and other international air services operating in the USSR. It could enhance the potential sale of U.S. ATC equipment to Eastern European countries. It would be consistent with our commitment to encourage scientific and technological cooperation with the USSR under the May 1972 Summit Agreement.

However, the type of equipment ultimately chosen by the Soviets could pose national security problems. DOD will apparently not object to approval of a turnkey type of proposal, covering moderate level technology in which only the maintenance system for whatever hardware exported is provided. Any extension to the system would be approved on a case by case basis by the USG. No information would be furnished which would enable the USSR to create new software systems or the management structure and development techniques necessary to such software creation.

The problems posed by the export of U.S. technology to the USSR have surfaced first in the aerospace field, where the U.S. predominates. We expect the same problems will occur in other areas as well.

U.S. Sugar Policy for the Future

A CIEP Sugar Study Group has been assessing the options open to us for new legislation to replace the U.S. Sugar Act which expires on December 31, 1974. An options paper is now in the final stages of preparation and will be before the Department shortly in anticipation of consideration by the CIEP Council around January 10. That meeting of the Council will be expected to decide on the general nature of the Administration's recommendations to the Congress for new sugar legislation. House hearings on new legislation are expected to begin early in February. Sugar policy has foreign as well as domestic political ramifications.

The Study Group has narrowed the field to three basic options:

--Continuation of the same general type of sugar program that we have had for nearly 40 years.

--Modification of the established program to open the domestic sugar industry and our foreign suppliers to greater competition but still retaining the basic nature of the established program.

--Complete elimination of U.S. Government intervention in the domestic sugar economy and sugar import trade except for the provision of deficiency payments to U.S. sugar growers to maintain their income level.

The present sugar law provides designated foreign countries with minimum shares of our market at U.S. prices. In most years U.S. prices are more favorable than world prices. In return for this preferential treatment, foreign countries are required to meet their quotas even when they can (as at present) get higher prices in other markets. This arrangement involves a complex system of quotas for sugar imports but has worked reasonably well to assure U.S. consumers of adequate supplies of sugar at reasonable and stable prices.

Virtually all of our foreign sugar comes from developing countries. The Philippines and Western Hemisphere countries account for the great bulk of it. All of them depend heavily on their U.S. quota, giving them an assured market at a reasonably stable price, for a significant portion of their foreign exchange earnings. This is an important factor in their development planning. Consequently nearly all of these foreign sugar suppliers have expressed serious concern over reports that some elements in the U.S. Government (i.e., Agriculture) are advocating abandonment of the sugar quota system in favor of a more open, market-oriented sugar program. To do so would evoke loud complaints from our traditional foreign suppliers.

Our sugar legislation is also traditionally a hot political issue domestically. Chairman Poage (House Agriculture Committee) has always taken a keen interest in sugar legislation and is a protagonist of the existing Sugar Act. He has characterized the Agriculture proposal for shifting to an open market system as "damned foolishness." The domestic industry (growers, processors, refiners, and industrial users) is somewhat split but the preponderant sentiment appears to us to favor continuation of something like the existing type of program rather than a shift to a radically new open market approach.

Detailed briefing material, together with recommendations on the Department's position for the January 10 CIEP meeting will be submitted shortly.

The U.S.-Canadian Auto Pact

The 1965 agreement between the U.S. and Canada providing for qualified free trade in automobiles has been unpopular with the Senate Finance Committee. The Finance Committee's hearings on the Trade Reform Act, probably beginning in early February, will be an opportunity for the Committee to press for either major changes in or termination of the agreement. They may hold the trade bill hostage for these actions.

Criticism of the agreement centers on the "safeguards" enforced by the Canadian Government, whose purpose was to ensure a continuing high level of production in Canada. We have long been negotiating with the Canadians for the elimination or suspension of these special safeguards. The Canadian auto industry is in no danger of moving south of the border--as the Canadian Government fears--even if the safeguards are dropped.

We have little hope that the current weak Canadian Government will agree to drop the safeguards at this time, or even to substitute less onerous requirements. But the Canadians are willing to discuss the matter. We hope to get interagency agreement on a proposal to be made to the Canadian Government, and to be able to present this to the Canadians early in the new year. We should persevere with these negotiations to give us an answer to Finance Committee critics--"we're still negotiating".

U.S.-EC Negotiations on Enlargement

For most of the past year the U.S. and other countries have been negotiating with the EC to obtain compensation for the tariff changes involved in accession of the U.K., Denmark, and Ireland to the EC. On December 13 the EC made its "final offer". We have informed the EC that this is unacceptable; we intend to present the EC with a formal request list and to continue to negotiate.

Ultimately, if we are not satisfied with the EC's offer, we could retaliate. If we were to do so, it could involve duty increases on nearly $1 billion worth of trade. Such action would strain US-EC relations, might lead to counter retaliation, and probably would result in the EC's abandoning the multilateral trade negotiations that have just got underway.

There will be two decision points with regard to retaliation. The Administration will need to decide between

February 1 and April 1, whether to institute the public hearings procedures required before retaliations. This action would not commit us to retaliate. It would serve two purposes: to position us to retaliate if necessary and to signal to the EC that we are truly serious. The decision whether actually to retaliate or not can be postponed until the end of May--and longer if the EC and the U.S. agree to an extension of the period in which retaliation is permitted by the GATT.